

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:8:LN:2:GL-POSTF-115967-02
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date: JUL 02 2002

to: Flora M. Basa
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from: GUY H. GLASER
Attorney (SBSE)

subject: [REDACTED] - Section 1341 Claim

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege.

ISSUES

1. Whether [REDACTED] (hereinafter collectively referred to as the "[REDACTED]"), in their capacity as transferees under I.R.C. § 6901, are entitled to relief pursuant to section 1341 of the Internal Revenue Code ("I.R.C. §1341 or "section 1341") with respect to repayments they made on a \$[REDACTED] federal income tax obligation of [REDACTED], Inc. ("[REDACTED]") for its [REDACTED] taxable year?

2. If the [REDACTED] are entitled to the relief requested, what amount are they entitled to deduct, in what year, and how should these deductible amounts be categorized (e.g., capital v. non-capital)?

CONCLUSIONS

1. In our opinion, unless the Internal Revenue Service ("Service") is able to clearly and convincingly establish that the [REDACTED] engaged in the underlying transaction fraudulently and with the intent to evade taxes, then the [REDACTED] should receive the section 1341 relief requested. Currently, in order to bolster this fraud theory, certain additional information needs to be secured. Our recommendations in this regard are set forth in more detail in the body of this memorandum.

2. As far as the second issue is concerned, and assuming that the government concedes that the [REDACTED] are entitled to section 1341 relief, at this time, we have insufficient information to determine whether the allocation of the section 1341 relief reported on the [REDACTED] returns for the [REDACTED] and [REDACTED] years is correct.¹

FACTS

A. History

1. Background

On [REDACTED], [REDACTED] became the [REDACTED]-percent shareholder of [REDACTED], Inc. ("[REDACTED]"), which was a holding company for [REDACTED], Inc. ("[REDACTED]"), [REDACTED] Inc. ([REDACTED]), and [REDACTED] Inc ("[REDACTED]"). Immediately before [REDACTED], [REDACTED] owned [REDACTED] percent of the shares of [REDACTED] shares) and [REDACTED] owned [REDACTED] percent ([REDACTED] shares). On [REDACTED], [REDACTED] redeemed [REDACTED]'s shares for \$[REDACTED] (\$[REDACTED] per share), and gave certain indemnities in [REDACTED]'s favor against claims which might subsequently be asserted as a result of pending lawsuits. The redemption price was negotiated at arm's length. [REDACTED]'s remaining [REDACTED] shares then became [REDACTED] percent of the stock. [REDACTED] was the [REDACTED] director of [REDACTED] from [REDACTED] through [REDACTED].

2. Liquidation Plan for [REDACTED] and Subsidiaries

During the last quarter of calendar year [REDACTED], [REDACTED] was advised that under the provisions of the [REDACTED] and its subsidiaries must adopt plans of liquidation on or before [REDACTED], in order to escape the eventual recapture of [REDACTED]'s LIFO reserve² of approximately \$ [REDACTED].

¹ On [REDACTED], the undersigned counsel attorney orally discussed with the Revenue Agent in charge of this matter what further items of information needed to be secured in order to address these issues. This information should be forthcoming within the next 30 days. As soon as practicable thereafter this information will be reviewed and analyzed.

² A LIFO reserve represents the difference between inventory valued at cost on a first-in, first-out basis and inventory valued at cost on a last-in, first-out basis.

In [REDACTED], [REDACTED] began discussions with [REDACTED], [REDACTED], and [REDACTED] to determine whether they would be willing to purchase [REDACTED] and its subsidiaries and to continue the operations thereof.

[REDACTED] had been associated with [REDACTED] from its inception and was in charge of its trading staff. [REDACTED] was executive vice president of [REDACTED] in charge of finance.

On [REDACTED], petitioner adopted a plan of liquidation calling for the liquidation and dissolution of [REDACTED] and its subsidiaries on or before [REDACTED].

3. Sale of Stock to [REDACTED]

On [REDACTED], [REDACTED] and [REDACTED] formed [REDACTED], a California general partnership. On the same day, [REDACTED] sold all the stock of [REDACTED] to [REDACTED]. The next day, [REDACTED] liquidated into [REDACTED], and [REDACTED] transferred to petitioner \$[REDACTED] cash as a downpayment. The cash originated in a [REDACTED] bank account.

The stock purchase agreement provided that [REDACTED] transfer his [REDACTED] shares in [REDACTED] to [REDACTED] for \$[REDACTED], subject to certain adjustments. The adjustments to the stock purchase price were to reflect increases or decreases in stockholders' equity between [REDACTED] and the closing date, and to reflect three outstanding lawsuits: (1) [REDACTED]; (2) [REDACTED]; and (3) [REDACTED]. The stock purchase agreement provided in relevant part:

[REDACTED]

[REDACTED] and [REDACTED] later amended the stock purchase agreement to reflect a purchase price of \$[REDACTED] consisting of a \$[REDACTED] note and \$[REDACTED] cash. The reduction in the stock purchase price from \$[REDACTED] to \$[REDACTED] represented, in substance, a transfer from [REDACTED] to [REDACTED] of the rights to the proceeds of the three litigations at issue, even though the litigations remained in [REDACTED]'s name and [REDACTED] directly received any recoveries from the lawsuits.

eventually received \$ in the litigation, representing a \$ judgment and \$ of attorney fees and interest. subsequently paid \$ as "an adjustment to the purchase price" for his Inc., stock. Additionally, petitioner received \$ from as a result of the litigation. As of , the was still seeking approximately \$ from .

as guarantors, entered into a Guarantee and Security Agreement on , guaranteeing 's payment and performance of its obligations under the note agreement. The guarantee is recourse to the extent of the value of 's partnership interests and is nonrecourse as to 's personal assets.

granted a security interest in all of the inventory, present and future accounts receivable, and other assets of including all assets received from and . At the request of petitioner subordinated his security interests to the bank.

In connection with the purchase of 's stock, gave the option to purchase their interests in for fair market value any time prior to . The stock sale was not an arm's-length sale. The litigation rights, \$ note, and \$ cash received in exchange for his stock greatly exceeded its fair market value. Indeed, as of , the consolidated balance sheets (Appendix) show liabilities in excess of assets in the amount of \$.

Just before the stock sale, entered into a barrel, \$ inventory transaction at the end of its tax year. The transaction spanned the periods immediately before and after the stock sale.

Id.

³ This transaction is the basis for the unpaid income tax deficiency of and also forms the basis of the payments made by the in their capacity as transferees for which they are now claiming section 1341 relief. See, infra.

<u>Date</u>	<u>Amount</u>
[REDACTED]	\$ [REDACTED]
Total	\$ [REDACTED]

5. Consulting Agreement

[REDACTED] at the request of [REDACTED] entered into a consulting agreement on behalf of his corporation, [REDACTED] Inc., with [REDACTED]. [REDACTED] spent approximately [REDACTED] to [REDACTED] percent of his time on [REDACTED]'s business as contrasted with [REDACTED] percent of his time prior to the [REDACTED] sale. After the sale of [REDACTED], petitioner rarely dealt with the customers and banks that transact business with [REDACTED]. After selling the stock of [REDACTED] and its subsidiaries, [REDACTED] acquired a refinery in [REDACTED], for approximately \$ [REDACTED], which competes with [REDACTED].

B. Assessment Against [REDACTED] for [REDACTED] Taxable Year Sham Inventory Transaction

As a result of the disallowance of the sham inventory transaction (involving the [REDACTED]), respondent determined a \$ [REDACTED] deficiency and additions to tax pursuant to section 6653(a)(1) and (2) against [REDACTED] for its taxable year ending [REDACTED]. [REDACTED] filed no petition, and on [REDACTED], respondent assessed the deficiency.

C. Transferee Liability against the [REDACTED]

On [REDACTED], the Service issued a notice of deficiency to the [REDACTED] in the amount of \$ [REDACTED] claiming that the [REDACTED] were responsible as transferees under section 6901 for the tax liabilities arising from the sham accounting transaction by [REDACTED]. The [REDACTED] disputed the Commissioner's claim

and filed a petition in Tax Court on [REDACTED].⁴ On [REDACTED], the Tax Court issued its opinion in [REDACTED], finding the [REDACTED] liable as transferees under section 6901 for [REDACTED] and [REDACTED]'s unpaid tax liabilities. In so holding, the Court found that:

(1) [REDACTED]

(2) [REDACTED]

[REDACTED]⁵

(3) [REDACTED];

(4) [REDACTED];

(5) [REDACTED]

(6) [REDACTED]

4 [REDACTED]

5 [REDACTED]

On [REDACTED] the Court entered judgement against the [REDACTED] for \$ [REDACTED] plus interest. See [REDACTED].

D. The Appeal and Settlement Agreement

On [REDACTED], the [REDACTED] filed a timely notice of appeal of the Tax Court's decision in [REDACTED] with the [REDACTED] Circuit Court of Appeals in the case of [REDACTED], and on [REDACTED], they filed a voluntary petition for bankruptcy. In [REDACTED], the [REDACTED] and the Government reached a settlement in [REDACTED] ("Settlement Agreement"), the pertinent provisions of which are described below:

Settlement Agreement

[REDACTED]

* * * * *

1. [REDACTED]

2. [REDACTED]

[REDACTED]

[REDACTED]

* * * * *

5. [REDACTED]
[REDACTED]:

(a) [REDACTED]

* * * * *

(b) [REDACTED];

(c) [REDACTED].

6. [REDACTED]
[REDACTED].

* * * * *

7. [REDACTED]
[REDACTED].

* * * * *

E. Section 1341 Claim for Relief

During their taxable year ending [REDACTED], the [REDACTED] paid \$ [REDACTED] of principal pursuant to the terms of the Settlement Agreement. On [REDACTED], the [REDACTED] filed a joint Form 1040 for the [REDACTED] year. On this return, the [REDACTED] claimed a Section 1341 deduction for [REDACTED] of the \$ [REDACTED] paid (\$ [REDACTED]). According to the [REDACTED], since the deduction in question related to income allegedly included in gross income under a claim of right in more than one taxable year, and since the amount attributable to each prior period could not be specifically identified, the [REDACTED] prorated the deduction over the taxable years from [REDACTED]-[REDACTED] (in accordance with Treas. Regs. §1.1341-1(d)(3)) and then allocated the prorated amount determined pursuant to I.R.C. §§ 1341(a)(4) and (5), as follows:

Schedule D Capital Loss	\$ [REDACTED]
Schedule A Ordinary Deduction	\$ [REDACTED]
Form 1040 Tax Credit	\$ [REDACTED]

During the taxable year ending December 31, [REDACTED], the [REDACTED] paid \$ [REDACTED] of principal pursuant to the terms of the Settlement Agreement. On their joint Form 1040 for the [REDACTED] year, the [REDACTED] claimed a Section 1341 deduction for [REDACTED] of the \$ [REDACTED] paid (\$ [REDACTED]). According to the [REDACTED], since the deduction in question related to income allegedly included in gross income under a claim of right in more than one taxable year, and since the amount attributable to each prior could not be specifically identified, the [REDACTED] prorated the deduction over the taxable years from [REDACTED]-[REDACTED] (in accordance with Treas. Reg. §1.1341-1(d)(3)) and then allocated the prorated amount determined pursuant to I.R.C. §§ 1341(a)(4) and (5), as follows:

Schedule A Ordinary Deduction	\$ [REDACTED]
Form 1040 Tax Credit	\$ [REDACTED]

LAW

Section 1341 was enacted to eliminate the inequity occasioned by such claim of right cases as North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932), and United States v. Lewis, 340 U.S. 590 (1951). In North American, the Supreme Court held that if a taxpayer receives earnings under a claim of right without restriction as to its disposition, it has received income which it is required to report, even though it may later be adjudged liable to restore it. North American, 286 U.S. at 424. Section 1341 enables taxpayers to ameliorate the sometimes harsh result of the claim of right doctrine, which requires reporting the income in the year of receipt. If it is later determined that the income must be repaid or restored, section 1341 gives taxpayers the ability in the year of restoration, to put themselves in the same position as if the income had never been reported.

The legislative history of section 1341 indicates that it was enacted to adequately compensate a taxpayer for the tax it paid for a prior year when it subsequently has been obliged to restore amounts included in gross income in the prior year because it appeared that it had an unrestricted right to such amount. See H.R. Rep. No. 1377, 83d Cong., 2d Sess., 86-87 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 118, 451 (1954); see also 108 Cong. Rec. S22531 (daily ed. October 5, 1962) (statement of Senator Kerr). Thus, the purpose of section 1341 was to place such a taxpayer at least in no worse a tax position than he would have been had he never received the income originally. Rev. Rul. 72-551, 1972-2 C.B. 508, 509.

Section 1341(a) provides that (1) if an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item; and (2) a deduction is allowable for the current taxable year because it was established after the close of such prior year (or years) that the taxpayer did not have an unrestricted right to such item; and (3) the amount of such deduction exceeds \$3,000.00, then the tax liability is the lesser of:

(i) the tax for the taxable year computed with such deduction, or

(ii) the tax for the taxable year computed without such deduction minus the decrease in tax under Ch. 1 of the Code for the prior year (or years) that would result solely from the exclusion of such item from gross income for such prior taxable year (or years).

Section 1341, therefore, enunciates five basic conditions that must be satisfied:

- (1) The item was included in gross income in a previous taxable year;
- (2) the inclusion was made under a claim of right and the taxpayer appeared to have an unrestricted right to the item;
- (3) in a later taxable year the taxpayer is entitled to a deduction on account of the repayment of the item;
- (4) the deduction is allowable because it was established after the close of the year of inclusion that the taxpayer did not have an unrestricted right to the item; and,
- (5) the amount of the deduction exceeds \$3,000.00.

Section 1341(b)(2) provides an exception to section 1341(a). Section 1341(a) does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

ANALYSIS

A. The [REDACTED] Will Not be Entitled to Section 1341 Relief If the Service Can Establish That the Sham Inventory Transaction Was Done Fraudulently with the Intent to Evade Taxes

Treas. Reg. § 1.1341-1(a)(2) defines "income included under a claim of right" to mean an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to the income. This section further notes that section 1341 requires that it be established, after the year of inclusion, that the taxpayer did not have an unrestricted right to the item of income in the year of inclusion. By requiring that it be established that the taxpayer 'did not have an unrestricted right,' the statutory language indicates that the lack of the right to the item of income must be a condition in existence in the taxable year of inclusion. It is only a determination, or establishment, that the taxpayer lacks an unrestricted right that occurs after the close of the taxable year.

Furthermore, if the taxpayer's right to the income is absolute and undermined by facts arising in a year subsequent to the year the income was received, the taxpayer does not satisfy the appearance of an unrestricted right test. Also, section 1341 does not apply if a taxpayer has no right whatsoever to income in the taxable year it is included in the taxpayer's gross income. Nor does it apply if the taxpayer voluntarily pays the income back in a subsequent taxable year. Thus, for example, although the proceeds of embezzlement constitute gross income in the year of embezzlement, they are held without any semblance of entitlement whatsoever and therefore a restoration of embezzled amounts does not come within the general rule of section 1341. Rev. Rul. 68-153, 1968-1 C.B. 371; Rev. Rul. 65-254, 1965-1 C.B. 50.

Not only does section 1341 not apply to embezzled income, it also does not apply to any type of "ill-gotten" gains, such as smuggling, kickbacks, and antitrust violations. See, e.g., Wood v. Commissioner, 863 F.2d 417 (5th Cir. 1989); Perez v. U.S., 553 F.Supp. 558 M.D. Fla. 1982); Hankings v. U.S., 403 F.Supp. 257 (N.D. Miss. 1975), aff'd by unpub. op. (5th Cir. 1976); Wood v. Commissioner, 863 F.2d 417 (5th Cir. 1989); Culley v. U.S., 2000-2 U.S.T.C. ¶50,662 (Fed. Cir. 2000); Zadoff v. U.S., 86-2 U.S.T.C. ¶9567 (S.D.N.Y. 1986); Field Service Advice 199921001, 200036006, 200036011 and 200036017 (requirement of appearance of unrestricted right to income item is not met where income item was obtained by fraud or intentional wrongdoing).

For example, in McKinney v. United States, 574 F.2d 1240 (5th Cir. 1978), cert. denied, 439 U.S. 1072 (1979), taxpayer embezzled from his employer, repaid the money and sought to take advantage of section 1341's tax recomputation. In holding against the taxpayer, the court noted that when the item was embezzled funds, it is clear that it could not appear to the taxpayer that he had any right to the funds, much less an unrestricted right to them. McKinney v. United States, 574 F.2d at 1243; see also Yerkie v. Commissioner, 67 T.C. 388 (1976); O'Hagan v. Commissioner, 70 T.C.M. 498 (1995), Rev. Rul. 68-153, supra; Rev. Rul. 65-254, supra.

Similarly, in Parks v. United States, 96-2 U.S.T.C. ¶50,645 (W.D. Pa. 1996), the court stated that "If the taxpayer commits fraud to obtain income, this court would not accept that such conduct can create the appearance of an unrestricted right to an item of income." Id. at 86,287.

Fraud is the intentional wrongdoing on the part of a taxpayer to evade a tax believed to be owing. See Petzoldt v. Commissioner, 92 T.C. 661, 698 (1989). In order to establish civil fraud, under the Internal Revenue Code and the Tax Court's Rules of Practice and Procedure, the government has the burden of proving by clear and convincing evidence (1) an underpayment of tax, and (2) that some part of an underpayment for that year is due to fraud. I.R.C. § 7454(a); Rule 142(b); Parks v. Commissioner, 94 T.C. 654, 660-661 (1990); Petzoldt v. Commissioner, 92 T.C. 661, 700 (1989); Hebrank v. Commissioner, 81 T.C. 640, 642 (1983).

1. Underpayment Of Taxes

In [REDACTED] and [REDACTED], the [REDACTED] reduced their income tax liability by [REDACTED] of dollars by claiming the alleged section 1341 adjustments which are at issue here. Such a reduction will clearly result in an underpayment of tax for both years, hence respondent will be able to clearly and convincingly establish that the [REDACTED] understated their taxable income for these years.

2. Fraudulent Intent

The second part of the test requires respondent to prove clearly and convincingly that some part of the underpayments for each year is due to fraud. I.R.C. § 7454(a); Rule 142(b); Parks v. Commissioner, supra; Petzoldt v. Commissioner, supra; Hebrank v. Commissioner, supra.

Fraud is defined as intentional wrongdoing on the part of the taxpayer with the specific intent to avoid a tax known to be owing, effectuated by conduct designed to conceal, mislead, or otherwise prevent the collection of such tax. Alexander Shokai, Inc. v. Commissioner, 34 F.3d 1480 (9th Cir. 1994), cert. denied, 514 U.S. 1062 (1995); Laurins v. Commissioner, 889 F.2d 910, 913 (9th Cir. 1989); Conforte v. Commissioner, 692 F.2d 587, 592 (9th Cir. 1992), stay denied, 459 U.S. 1309 (1983); Webb v. Commissioner, 394 F.2d 366, 377 (5th Cir. 1968), aff'g T.C. Memo. 1966-81. The existence of fraud is a question of fact to be resolved upon consideration of the entire record. King's Court Mobile Home Park, Inc. v. Commissioner, 98 T.C. 511, 516 (1992). Fraud is never to be presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). To support a finding of fraud, the Commissioner must show that a taxpayer intended to evade the collection of taxes by conduct designed to conceal his liability, to mislead the tax collector, or otherwise prevent the collection of taxes known or believed to be owing. Spies v. United States, 317 U.S. 492, 499 (1943); Patton v. Commissioner, 799 F.2d 166, 171 (5th Cir. 1986); Korecky v. Commissioner, 781 F.2d 1566, 1568-89 (11th Cir. 1986). Because there rarely is direct evidence of fraud, fraudulent intent can be inferred from circumstantial evidence. Spies v. United States, 317 U.S. at 499; Alexander Shokai, 34 F.3d at 1486; Bradford v. Commissioner, 796 F.2d 303, 307 (9th Cir. 1986); Niedringhaus v. Commissioner, 99 T.C. 202, 211 (1992). Respondent's burden of establishing fraud, however, is met only if he is able to clearly and convincingly show that the taxpayer intended to conceal, mislead, or otherwise prevent the collection of taxes. I.R.C. § 7454(a); Rule 142(b); Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983).

The case of United States of America v. Ingredient Technology Corporation, f.k.a. Sucrest Corporation, 698 F.2d 88 (2nd Cir. 1983) is instructional. In that case, Ingredient Technology Corporation f.k.a. Sucrest Corporation ("Ingredient") was engaged in the sugar refining business, and used the last in, first out ("LIFO") method to account for inventory. To preserve its LIFO base and minimize taxable income, the president of Ingredient caused the company to enter into a sham arrangement which overstated inventory. The Second Circuit Court of Appeals, upheld the lower court's criminal conviction of the President of the company under Title 18 U.S.C. § 371 (Conspiracy to defraud to evade payment of tax) and Title 26 U.S.C. § 7206 (filing a false return), finding that he had willfully engaged in a sham inventory transaction to evade payment of corporate income taxes and had engaged in tax fraud. Id.

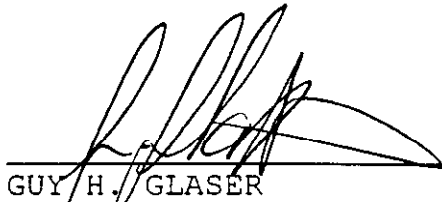
In our opinion, the facts arguably demonstrate that [REDACTED] knowingly undertook and participated in the sham inventory transaction of [REDACTED] in an effort to mislead the Service and avoid and prevent the collection of tax which he knew was owing so that he could personally subsequently "reap" the benefits of such underreporting of taxes through distributions to be made to him in the future from the contemplated corporate liquidation of the corporation. In such case, we believe that such intentional wrongdoing might preclude the use of section 1341 by the [REDACTED] in their capacity as the transferees of [REDACTED]'s liability. Rev. Rul. 68-153, 1968-1 C.B. 371.

At this time, however, we are somewhat reluctant to further pursue this civil fraud argument until we have had the opportunity to more closely examine all of the underlying facts and circumstances surrounding the opinion issued by the Tax Court in [REDACTED] and leading up to the creation of the Settlement Agreement. To that end, we recommend that all of the following information be obtained immediately:

- a) All of the Commissioner's legal and administrative files in the matter of [REDACTED];
- b) All of the Department of Justice's files in [REDACTED]; and,
- c) All information and documents in the possession of the Department of Justice relating to the creation of the Settlement Agreement.

Once this information has been obtained, reviewed and scrutinized we will revisit the conclusion set forth in this memorandum.

If you have any further questions concerning this matter, please do not hesitate to contact the undersigned attorney at (949) 360-2687.



GUY H. GLASER
Attorney (SBSE)